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SEC increases Rule 701 disclosure threshold and issues concept release on updating compensatory offering rules

The SEC recently amended Securities Act Rule 701, which provides a registration exemption for securities sold by non-reporting companies to their employees and other covered persons under compensatory arrangements. The amendment revises Rule 701(e) to increase from US$5 million to US$10 million the limit on the aggregate sales price or amount of securities a company may sell during any consecutive 12-month period without having to deliver additional disclosure to offerees. The amendment, which is available ***here***, became effective on July 23. Companies may rely on the increased disclosure threshold for offerings that were ongoing when the amendment became effective, as well as for offerings they initiate after the effective date.

On the same day it published the Rule 701(e) amendment, the SEC issued a concept release soliciting public comment on ways in which the SEC might modernize its rules governing compensatory securities offerings. SEC Chairman Jay Clayton has indicated that the concept release represents an effort to ensure that the regulatory framework for compensatory offerings reflects recent changes in the labor markets. Among those changes, Chairman Clayton highlighted "the development of both new compensatory instruments and novel worker relationships – often referred to as the 'gig economy.'" The SEC requests comment by September 24 on potential modifications to Rule 701 and to Form S-8, which is the Securities Act registration statement form used by reporting companies for compensatory offerings. The concept release is available ***here***.

Rule 701 and Form S-8 today

The SEC observes in its concept release that it has "long recognized that offers and sales of securities as compensation present different issues than offers and sales that raise capital for the issuer of the securities," in part because the company has a different relationship with offerees in a compensatory offering than it has with offerees in a capital-raising transaction. To accommodate these differences, the SEC adopted Rule 701's limited exemption from Securities Act registration for compensatory offerings by non-reporting companies, and the simplified Form S-8 registration statement for use by reporting companies in registering compensatory securities.

Rule 701. Non-reporting companies commonly rely on Rule 701 to grant equity-based compensation awards. Rule 701 provides an exemption from Securities Act registration for offers and sales of securities under certain compensatory benefit plans or written agreements by any non-reporting domestic company or non-reporting foreign private issuer that is not an investment company registered (or required to be registered) under the Investment Company Act. The exemption covers securities offered or sold under a plan or agreement to company employees and other covered persons. Rule 701(b) permits a company that becomes subject to Exchange Act reporting requirements after it has made offers in reliance on Rule 701 to continue to rely on the rule to sell the securities previously offered to the persons to whom it made the offers.

12-month cap on Rule 701 sales. The aggregate sales price or amount of securities a company may sell in reliance on the exemption during any consecutive 12-month period may not exceed the greatest of:

— US$1 million;

— 15% of the total assets of the company, measured at the company's most recent balance sheet date; and

— 15% of the outstanding amount of the class of securities being offered and sold in reliance on the rule, measured at the company's most recent balance sheet date.

A company may measure the 12-month period either on a fixed or on a rolling 12-month basis, so long as the company applies the measurement period consistently.

Disclosure requirements under Rule 701(e). Rule 701(e)'s disclosure requirements vary with the aggregate sales price or amount of compensatory securities sold. A company in all cases must provide offerees a copy of the compensatory benefit plan or agreement. In addition, the company must deliver additional disclosure if the aggregate sales price or amount of securities sold by it during any consecutive 12-month period exceeds a specified threshold, which was US$5 million before the new rule amendment and is US$10 million today.

The additional disclosure consists of the following information:

— A summary of the material terms of the compensatory plan or agreement

— Information about risks associated with investment in the securities sold

— Financial statements of the company satisfying the requirements of Part F/S of Form 1-A under Regulation A, dated not more than 180 days before the date of sale

The company may decide to deliver information in addition to the disclosure prescribed by Rule 701(e) if it considers the additional information necessary to satisfy the anti-fraud provisions of the securities laws.

On an issue it takes up in the concept release, the SEC reminds issuers that, consistent with the operation of Rule 701(e) before the amendment, if aggregate sales during the applicable 12-month period exceed the US$10 million threshold, the company must deliver the additional disclosure a reasonable period of time before the date of sale to "all investors in the 12-month period." If the company fails to do so, it will lose the exemption with respect to all of those investors, including those to whom the company made grants before it crossed the threshold.

Eligible participants under Rule 701. Rule 701 exempts from Securities Act registration compensatory securities offered or sold to a company's employees, officers, directors, partners, trustees, consultants, and advisors. Rule 701 also is available for sales of securities (such as upon the exercise of stock options) to family members of these individuals who acquire such securities through gifts or domestic relations orders. The company may rely on Rule 701 to sell compensatory securities to consultants and advisors who are natural persons and provide bona fide services to the company or specified affiliates of the company which are not provided in connection with the offer or sale of securities in a capital-raising transaction. An eligible recipient also includes a person in a "de facto employment relationship" with the company, such as a non-employee providing services that traditionally are performed by an employee, so long as the compensation the company paid for those services constitutes the primary source of the person's earned income.

Form S-8. Form S-8 is available for registration of securities to be offered by a reporting company under an employee benefit plan to the company's employees, or to employees of its subsidiaries or parent. A company's employees for this purpose includes consultants, advisors, and de facto employees.

The SEC observes in the concept release that, from time to time in the past, it has amended Form S-8 to "streamline its operations," including by providing for immediate effectiveness of the registration statement upon filing and by permitting companies to update the prospectus through incorporation by reference of Exchange Act reports and other filings. Form S-8 does not require that a company file a form of prospectus with the registration statement, so long as the company provides to plan participants specified documents constituting a prospectus.

Rule 701(e) amendment

The amendment to Rule 701(e) adopted in July was mandated by the Economic Growth, Regulatory Relief, and Consumer Protection Act, which was signed into law in May 2018. As previously indicated, the amendment increases from US$5 million to US$10 million the aggregate sales price or amount of securities sold during any consecutive 12-month period in excess of which the issuer is required to deliver to participants the additional disclosure described above. The SEC indicates that the statutory mandate to increase the disclosure threshold responded to concerns “that the additional disclosure makes it more expensive for companies to compensate their employees with the company’s stock and that this disclosure puts non-reporting companies at risk of disclosing confidential financial information.” As discussed in the concept release, some companies have been discouraged from relying on Rule 701 because of concern that their competitors might obtain access to the additional disclosure.

Except as required by the higher size-of-offering threshold for additional disclosure, Rule 701(e) as amended will continue to operate in the same manner as it operated before the amendment.

Concept release on modernizing compensatory offering rules

In its concept release, the SEC explores some major implications for the compensatory offering regime of the significant evolution in recent years in the types of compensatory offerings companies make and the nature of their relationships with the individuals who do work for them.

Modifying scope of eligible participants under Rule 701 and Form S-8 to address the “gig economy.” The SEC highlights the new types of contractual relationships arising between companies and individuals in the labor force largely as a result of the internet. These relationships include “short-term, part-time or freelance arrangements,” and frequently involve the individual’s use of the company’s internet platform for a fee to find business, provide services, sell goods, or lease property. Individuals who use these internet platforms often have similar relationships with multiple companies.

Because many of the individuals lack a traditional employment or consultant relationship with the company they work for, those individuals may not be eligible to receive securities under either Rule 701 or Form S-8 – including as consultants, advisors, or de facto employees – in light of how SEC rules currently define those roles. The SEC poses a series of questions relating to the characteristics of contractual relationships that might provide a basis for expanding eligibility for the Rule 701 exemption or for use of Form S-8. The agency asks for comment on the following issues, among others:

- Whether the definitions of “employee” under other regulatory regimes should be applied for eligibility purposes
- What services, if any, an individual working in the gig economy should be providing to a company in order to be an eligible participant
- Whether eligibility should require that the company exercise some level of control over the individual providing the services, such as requiring the work to be assigned by the company
- Whether eligibility should be affected by whether the individual is paid directly by the end user rather than by the company whose platform the individual is using
- Whether the eligibility test should take into account the individual’s level of dependence on the company
- Whether differences in eligibility standards as between Rule 701 and Form S-8 would cause problems for companies or participants

Modifying manner and content of Rule 701 disclosure. Although the Rule 701(e) amendment increased the size-of-offering threshold for additional disclosure from US$5 million to US$10 million, companies still must anticipate, up to 12 months in advance, whether an offering ultimately might cross the threshold before the 12-month period ends. If a company fails to provide the required disclosure to all investors before it crosses the threshold, the company may not rely on the Rule 701 exemption, which will be lost for the entire offering.

The SEC acknowledges that, as many securities-law practitioners can attest, it can be difficult to predict with confidence the level of required disclosure for a 12-month period before making the initial sales in an offering. Therefore, among other questions focused on this concern, the SEC requests comment on whether the consequence for failing to provide the disclosure should be loss of the exemption only for transactions that occur *after* the company crosses the US$10 million threshold and for which it did not provide the appropriate disclosure, or alternatively, if it crosses the threshold, whether the company should be afforded a “grace period” to provide the required disclosure before losing the exemption. In addition, the SEC asks whether the requirement to deliver applicable disclosures "a reasonable period of time before the date of sale" should be modified, or at least clarified.

The SEC recognizes that "non-reporting companies are sensitive to maintaining the confidentiality of financial information so that it does not fall into the hands of competitors." The SEC goes on to raise several questions regarding whether Rule 701 should specify the manner or medium in which an issuer should deliver disclosure, and requests comment regarding the vehicles which "would best give effect to the purpose of disclosure" without undermining the confidentiality of the information provided.

In this regard, it is worth recalling that in its 2007 adopting release for Exchange Act Rule 12h-1(f)(1), which provides an exemption from Section 12(g) registration for compensatory stock options, the SEC stated that, to protect the confidentiality of information delivered under that rule, a company may satisfy the disclosure requirement by giving option holders access to the information on a password-protected internet site accessible on a restricted basis. Further, in letters granting no-action relief from Exchange Act registration before the adoption of Rule 12h-1(f)(1), the SEC staff indicated that it would be permissible for companies to make the information required by Rule 701 available for inspection only during normal business hours at the company's offices. These accommodations might provide a promising approach to addressing continuing concerns over the confidentiality of Rule 701 disclosure.

The SEC goes beyond questions addressing modes of delivery to request comment on the content of the required Rule 701 disclosure. The SEC raises for consideration whether the Regulation A financial statement disclosure requirements should depend on the type of employee that is receiving the securities and, more generally, whether the SEC should consider alternatives to Regulation A financial statements as the basis for disclosure, particularly in light of the fact that many companies are not familiar with Regulation A requirements.

Clarifying timing of disclosure to recipients of restricted stock units (RSUs). The SEC notes that securities such as RSUs have become more prevalent forms of compensatory awards since it last amended Rule 701, and raise issues about when Rule 701 disclosure should be provided to award recipients. The SEC expresses the view that, because RSUs settle by their terms without the recipient taking any action to exercise or convert the instrument (as would be the case with a stock option exercise), the "relevant investment decision for the RSU, if there is one, likely takes place at the date of grant." In this case, the company would be obligated to provide Rule 701 disclosure a reasonable period of time before the date on which it makes the RSU award. The SEC identifies potential concerns regarding this timing, including the concern that requiring disclosure of financial information before a company grants an RSU could compel the company to deliver disclosure to intended recipients at a time when they are still negotiating their employment contracts and before they have committed to join the company.

The SEC requests comment regarding when disclosure should be required for RSUs. The SEC also raises the question of how companies should value RSUs for Rule 701 purposes, and whether there are other derivative securities the agency should specifically address in Rule 701.

Modifying annual ceiling on Rule 701 grants. The SEC also invites comment on the issue of "whether the current 12-month sales cap... is unduly restrictive, particularly for smaller and start-up companies that may be more dependent on equity compensation to attract and retain necessary talent." The SEC originally intended the annual sales cap to ensure that small issuers would not use Rule 701 to raise substantial capital from employees on an exempt basis. The SEC notes the position of some interested parties that, at least in part because there is no longer a statutorily-imposed ceiling on the Rule 701 exemption (as there was at the time of the rule's adoption), "compliance with an annual regulatory ceiling requires an on-going analysis with no clear benefit." The SEC asks whether there is a continuing need for an annual ceiling and, if there is such a need, if the current cap should be raised (and by how much).

Reducing the complexity and cost of compliance with Form S-8 requirements. The SEC says it remains interested in simplifying the requirements of Form S-8 and reducing compliance costs for issuing securities to eligible participants. The agency therefore seeks views on ways in which it could further reduce the burdens associated with Form S-8. In particular, it asks:

— Whether the requirement to register a specific number of shares exposes companies in some circumstances to problems in complying with Securities Act registration, such as in connection with 401(k) plans (which raise knotty share-counting issues), and, if so, how the agency should address such problems

— Whether Form S-8 should allow a company to register on a single form the offers and sales pursuant to all of the employee benefit plans that it sponsors

— Whether companies should be able to add securities to an existing Form S-8 by an automatically effective post-effective amendment

— Whether the filing fee rules for Form S-8 should be changed and, if so, in what way

The SEC also raises for comment the possibility of broader structural changes to its compensatory offering scheme, including whether it might be advantageous to extend the Rule 701 exemption to reporting companies and thereby eliminate Form S-8 altogether. The release goes on to ask questions relating to whether such an action would raise any investor protection concerns, and how the SEC might best implement such a change.

Conclusion

Although the Rule 701(e) amendment was of limited scope, it is clear from the concept release that the SEC is giving serious thought to more sweeping reforms of its rules governing compensatory offerings. The concept release reflects the SEC's recognition of the fact that applying the existing rules for such offerings in the new "gig economy" may prove unduly restrictive for many companies. It is likely that many of the ideas floated in the concept release will appeal to employers, employees, and other service providers alike, and that adoption of revised rules would advance the SEC's objective of reducing the burden on companies attempting to attract and retain talent through the use of equity-based incentive programs.

This SEC Update is a summary for guidance only and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed on the following page of this update.

Contacts

Peter J. Romeo (Co-editor)
Washington, D.C.
peter.romeo@hoganlovells.com
T +1 202 637 5805

Alan L. Dye
Washington, D.C.
alan.dye@hoganlovells.com
T +1 202 637 5737

Richard J. Parrino (Co-editor)
Washington, D.C.
richard.parrino@hoganlovells.com
T +1 202 637 5530

Michael Frank
Silicon Valley
mike.frank@hoganlovells.com
T +1 650 463 4097

C. Alex Bahn
Washington, D.C.; Philadelphia
alex.bahn@hoganlovells.com
T +1 202 637 6832 (Washington, D.C.)
T +1 267 675 4619 (Philadelphia)

Kevin K. Greenslade
Northern Virginia
kevin.greenslade@hoganlovells.com
T +1 703 610 6189

Margaret de Lisser
Washington, D.C.
margaret.delisser@hoganlovells.com
T +1 202 637 6436

Martha Steinman
New York
martha.steinman@hoganlovells.com
T +1 212 918 5580

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
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